RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Feb. 22, 1989 **LETTER 1011**

Feb 10 DJIA 2286.87; PTI 2899; A-D Ratio -10.08
Feb 16 DJIA 2311.43; PTI 2910; A-D Ratio -9.87
Current Dow Yield: 3.63; Dow P/E: 12.6
Dow Book Value: 1008; Dow 200-day MA: 2121
DowPow: 871
Percentage of Undervalued blue-chips: 19%

THE PICTURE: It looks very much as though (under President Bush) the fiscal charade is fated to continue. Bush wants to use the "buddy system" in his relations with Congress. The problem is that the Democrats aren't going to be his buddies, and already spending-minded Dems are saying that the Bush "flexible freeze" looks more like a "flexible squeeze." "It's a thousand points of light without the batteries," complained one prominent Democrat.

Here's the real story. Before leaving office Mr. Reagan presented his own budget for 1990, which listed spending of $1.151 trillion and revenues (very hopefully) of $1.059 for a projected deficit of $92.5 billion. Enter President Bush with his own revised budget of February 9. Bush listed total spending of $1.160 trillion (up 8.6% from the Reagan budget) and revenues (very hopefully) of $1.069 trillion for a projected deficit of $91.1 billion (good luck to both budgets).

Nowhere in Mr. Bush's fuzzy budget did he show where he would get his cuts or his boosts in revenue, and seasoned observers were left scratching their heads or sighing in disbelief. I might add that neither of these phoney budgets admitted to massive borrowings from the Social Security and other trusts. In the face of the latest budget nonsense, the bond market promptly swooned.

On February 10 the government released the news that the Producer Price Index jumped a full 1% (biggest monthly pop in eight years) for a compound annualized inflation rate of 12.7%. In the face of that rather shocking news, all eyes turned to the Fed. The Fed has been holding off on raising the discount rate, but at this point their reluctance is almost as comic as it is pathetic. Mr. Greenspan's hesitancy stems from his obvious knowledge that one more discount rate boost (it would be the third successive increase) would set off the well-known "three-step-and-stumble" rule. This rule has always constituted a major sell signal for the stock market. Furthermore, with the US now leveraged to the hilt the Fed must be wondering at what point rising interest rates would trigger an unraveling of the US economy.

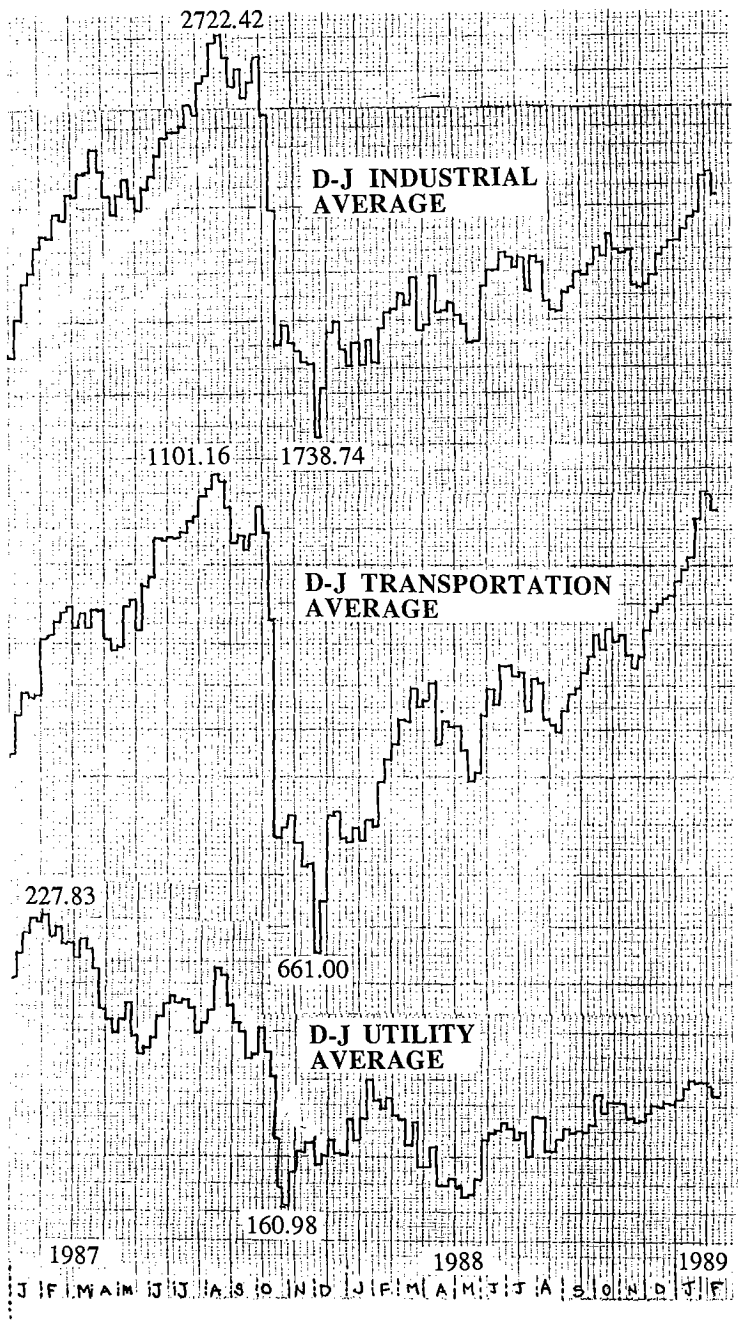
As far as I'm concerned, the whole thing is out of the Fed's hands. As I've said many times before, it's the **markets themselves** (the debt markets and the currency markets) that are running the show today. These markets have grown so huge, so sophisticated, so international, that they now dwarf any manipulations that can be brought to bear by the Fed, the Treasury or even by the central banks. When, somewhere ahead, the markets again say "enough" (as they did in October 1987) the trigger will be pulled for the second time in this bear market. When or where will the "enough" signal come? I don't know, but I do know that it's coming.

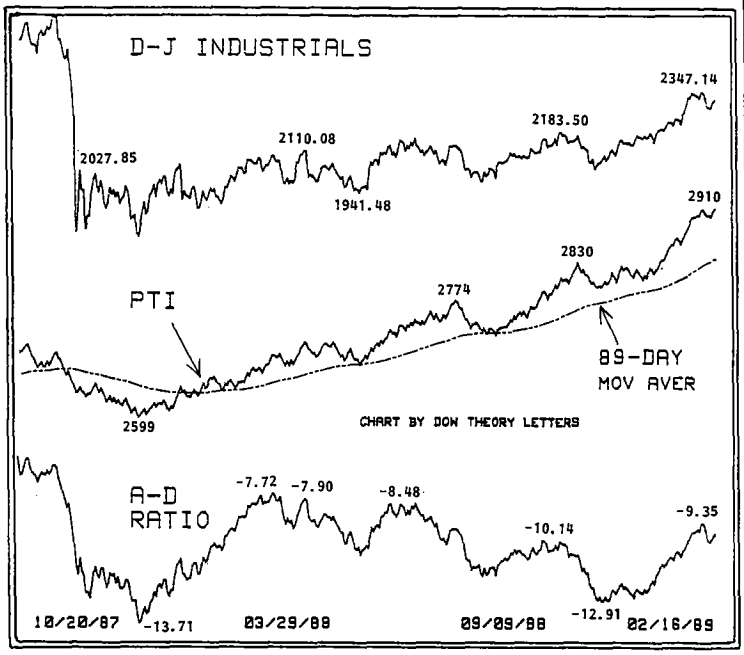
Perhaps the best comments on the whole subject were made by Chuck Bowden in his opening paragraphs for a guest column in *USA Today:*

> TUCSON, Ariz. — For decades, the worst miniseries on television has been an episodic soap opera spun around presidents giving speeches. The scripts are poor, the actors hacks, the piot lines unbelievable.
>
> We've just tried the ultimate remedy — hiring a professional actor for the past eight years — and even he couldn't breathe any life into this stuff.
>
> Now, Poppy Bush has taken over the role as the gentle Maine-Connecticut-Texan who sings about the budget (we never follow it) and the deficit (it always grows larger).

* *

Instead of the usual page 1 daily chart of the D-J Averages, I have included a longer-term ratio chart in this report. What you see here are the weekly Friday closings of the Industrials, Transports and Utilities from January 1987 to date.





What I wanted to show is the current position of the three Averages in relation to their 1987 bull market highs. As noted in the last letter, the Transportation Average, at its recent high, was within shooting distance of its August 1987 bull market peak of 1101.16. Thus, there is a chance that the Transports could still rally to a new high above the '87 high. The Dow, however, is currently around 400 points below its comparable 1987 bull market high, that high being 2722.42. Finally, the Utility Average, which topped out on January 27, 1987 at 227.83 is still well below its 1987 bull market high.

What intelligent observations, if any, can be drawn from this chart? For one thing, it has now been 16 months since the August 1987 bull market peak, and despite a booming economy the Averages have been unable to better their bull market highs. Although the progress so far has been impressive, one has the feeling that time may be running out for the recovery. How hot does the economy have to get and how rosy does the forthcoming picture have to be in order to propel the Averages over their '87 highs? It's a question any serious bull must be asking himself at this point (particularly in view of rising interest rates).

As noted, the Utility Average is still well below its January 1987 high. Back in 1960s, the Utility Average (often a bellwether for the general market) was the first to top out in that bull market. In fact, the D-J Utility Average hit its high on April 20, 1965 -- a full 10 months ahead of the final bull market peak in the Dow (recorded on February 9, 1966). In the present situation, more than two years have passed since the January 1987 Utility high.

As a rule, markets don't just run up to a peak and then fall apart. Most market tops are accompanied by a technical failure -- usually a non-confirmation in the Averages. Thus, if the Transports now rally above their recent February high of 1087.97, it will be important to see whether the Dow (which has been considerably weaker than the Transports) can confirm by bettering its own February 8 high of 2347.14. A second possibility would be the Transports rallying above their 1987 bull market high of 1101.16, in which case, the Dow would most definitely not confirm.

My PTI continues to act bullishly, giving up very little so far on any market weakness. DowPow finally bettered a previous peak but continued to lack convincing upside power.

INVESTMENT POSITION: At this point it seems to me that the best risk/reward situation is in two-year or three-year Treasury notes yielding better than 9%. True, this isn't a very exciting investment. But to me, 30% compounded over three years is exciting enough, and the fact is that there aren't too many items that will give you that kind of appreciation with absolute safety.

The bear is in the box, and that's the picture for long-term investors. For traders, my PTI is still holding above its 89-day moving average, and it would take persistent weakness to push the PTI into a bearish mode (i.e., to push it below its moving average).

In the face of higher interest rates, gold, bonds and stocks have been under pressure. The danger here is not in the higher rates, it's what happens to leveraged, LBO'd America, as rates continue to push higher or as they just stay high. Every 1% rise in rates adds $5 billion to the federal deficit, and every rate boost costs Americans billions in their variable-rate mortgages, and every boost in rates shoves more S&Ls into the "belly-up" area.

HAS THE TOP BEEN SEEN? Probably the biggest question facing Wall Street and the nation is this: "Was August 1987 the top for the great 1974-87 bull market -- or does the top lie somewhere ahead?"

The only reason this question is even being asked, of course, is because of the big advance since the crash low of October 19, 1987. The rise since then has prompted many investors and advisors to opine that "the crash of '87 was simply a weird, once-in-a-lifetime interruption in the bull market, and the bull market is now continuing."

Subscribers know that I am not of that opinion. My opinion is that the 1101.16 high in the D-J Transportation Average and the 2722.42 high in the D-J Industrial Average represented the top for the great bull market. Yes, it is conceivable that one Average or the other could rally to a new solo high, but a bull market top is identified as the point where both Averages record their last joint highs.

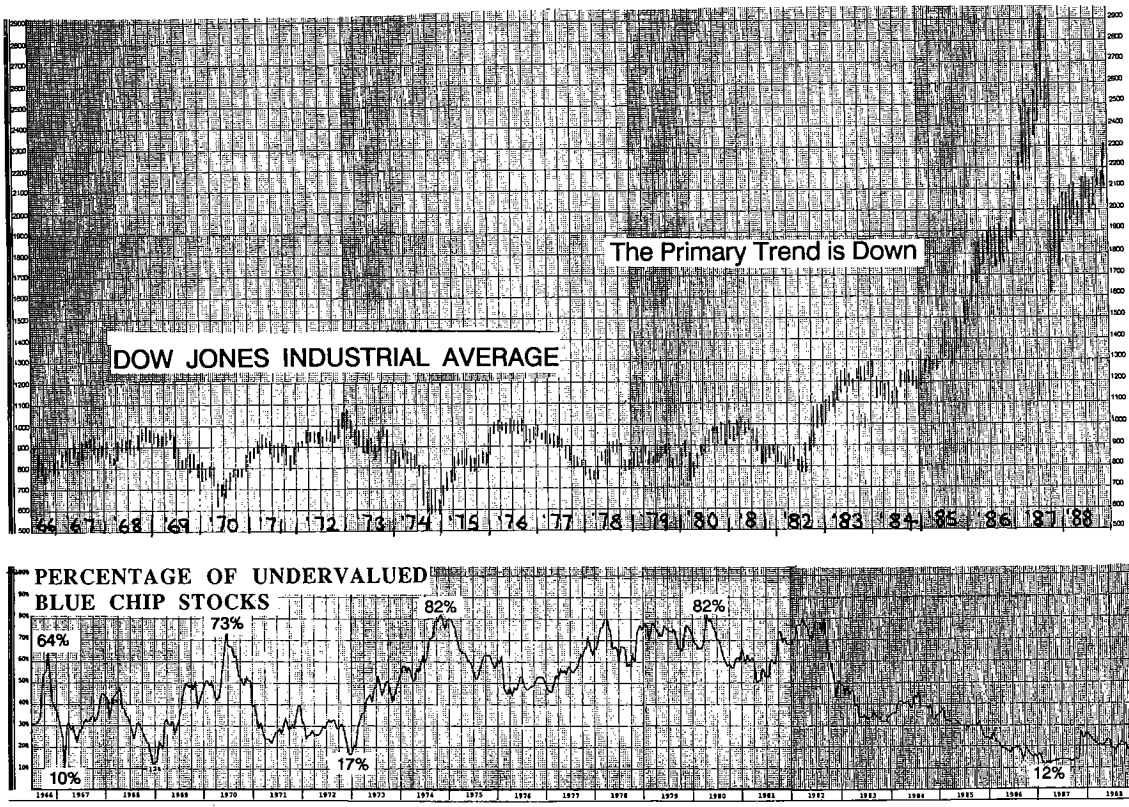
Furthermore, judging from the action of the advance-decline ratio and the major composite indices, I would say that the majority of stocks (of all kinds) saw their highs during 1987. The public, which holds a wide assortment of shares, sees this and senses this. The public also sees that it is not "getting its money back" on stocks bought prior to the crash, and it is this shock and realization that has kept the public from coming back to the market.

To me, one of the best proofs of the 1987 top is seen in the page 3 chart of the "undervalued stocks" as published by *Investment Quality Trends* here in La Jolla. For many years *IQ Trends* has monitored a universe of 350 blue-chip dividend paying stocks. Each stock is graded bi-monthly on the basis of its dividend yield in relation to its own historic yield perimeters. In other words, a stock such as GM might fluctuate within a dividend channel between 9% and 3%. When GM yields 3% then historically it is "undervalued." When it yields as much as 9% it is "overvalued."

IQ Trends grades each of their 350 blue-chip stocks twice monthly, and at each tabulation they come up with the percentage of their 350 stocks which are undervalued.

The chart identifies areas of tops and bottoms beautifully. The chart tells us that when the undervalued percentage is above 73% and certainly above 80% the market is in bottom territory -- at that point we are near a bear market bottom as seen in the high percentage of bargain blue-chip stocks.

Conversely, when the undervalued percentage drops to 17% or below we are nearing or in an area of major tops. Note that during



Comment: As you can see on this chart there has never been a time when the undervalued percentage has held so long in a low or overvalued area. This adds to my thesis that the whole period since early-1987 constitues one huge topping process for the market. What the final result of this huge overvalued area will be can't be known. All I can say is that I don't like the looks of it.

1987 the undervalued percentage dropped to a dangerously thin 12%. At that time very few blue-chip stocks were undervalued, a situation that told us that the market was in an area of a major top. The top was confirmed on October 15, 1987 when the Dow Theory gave a primary bear market signal. A few days later the market crashed.

What has happened since? The undervalued percentage has hung around 20% to 25%. But the latest undervalued figure is down to 19%. In my opinion, as stated at the beginning of the last Letter, the entire period of early 1987 to the present (including the crash) is all part of one major, "super-top" for the market. I believe the chart above supports that view. Certainly, at no time since the 1987 highs has the undervalued percentage of blue-chips moved anywhere near the zone where it would suggest that a new bull market has started.

And based on the current 19% undervalued, it is clear that the market is again in the danger zone. An area where only 19 out of every 100 blue-chip stocks can be termed an overvalued area, based on past history.

CHANGE: I don't know why or how I first got interested in the stock market, but I'm sure it had to do with my fascination with change. Every person has some area of talent, expertise, or outstanding ability. If I possess any of these I believe it lies in my ability to sense or recognize change. And I say this realizing that most people tend to think that things will always go along as they have in the past. I've never felt that way, and, in fact, I've always been interested in and sensitive to change.

I think my first recognition of change came in the world of music. Back in the '40s when I was in high school I fell in love with jazz. A few of the guys in my school class (class of '42) would take the subway up to Harlem -- to a nightclub on 116th Street at Lenox Avenue called Minton's. Around midnight (after their regular gigs), many of the top black jazz musicians would meet at Minton's to "jam" the night away. There we were, a few white kids in a sea of dark faces and fascinated with jazz (but the club owner, Teddy Hill, a famous black band leader, couldn't have been nicer to us).

I had seen them all, all the great ones: Lester Young, Roy Eldridge, Art Tatem, Teddy Wilson, Billy Holliday, Coleman Hawkins, the Duke of Ellington, Count Basie. All came to Minton's sooner or later. But there was one fellow who was different. He was a bearded piano player named Thelonius Monk. Monk's piano was unlike anything I had ever heard before. This guy played wonderful, weird music. A young trumpet player, called Dizzy Gillespie, liked Monk's exotic one-finger style, and the two of them seemed to have a great rapport. I honestly couldn't tell if I liked this "new" kind of jazz or not, but it certainly was different.

I couldn't get the Monk piano music out of my head. It fascinated me. I thought to myself, "Something important is happening here. These guys are changing music." Later I found out why I was so enthralled. I was watching the beginning of "modern jazz" (in its early phase it was called be-bop).

Gillespie and Monk are now folk heros. They're part of the history of American music. And I think to myself, I was there at the beginning. I saw music changing. ...

It was early 1945. I was bombardier and gunner on a B-25 medium-bomber with the 12th Air Force out of Senigalia, Italy. I remember this as clearly as if it happened an hour ago. One chilly morning my squadron took off on a routine mission. Our job was to knock out bridges and bomb and strafe troop trains in northern Italy near the Brenner Pass. It was about 7 a.m. as my squadron circled the field repeatedly as we picked up other bomb squadrons and groups along with our fighter cover.

When the group was assembled, we headed north. I was squatting there in the plexiglas nose of the plane, leaning over the Norden Bombsight, and adjusting my flak suit. I looked up, and a chill went through me. It was a moment that froze in my mind. Above us were groups of "heavies," the big B-24 Liberator bombers. Below us and climbing were General Ben Davis' squadrons of P-47 Thunderbolt fighters (these guys were the only black fighter pilots in Europe and they were very good). Flying at our side were squadron upon squadron of the sleek, beautiful P-38 Lightning fighters. Ahead of us were countless other groups of bombers, both mediums and heavies. It was like a fantastic vision from another world. Squadrons, groups, medium bombers, heavy

bombers, fighters -- the sky, the whole sky as far out as I could see in every direction, was alive with American war planes. The scene was electric, the very skies were vibrating. I sat there as if in a dream.

Suddenly, crouched there in the nose of that B-25 I started shouting like a crazy man. For I knew at that moment that the war was over. Nobody, no power on earth could possibly withstand what I was seeing that day in the skies over Italy. It was like the wrath of God heading north to bomb the Axis powers into oblivion. The big change was coming, and I knew that interminable war (impossible as it seemed) was in its waning days.

I've had a few experiences in the stock market that remind me just a little bit of that day in 1945. In late-1958, the US was experiencing a severe recession. I don't know if that recession will go down as the worst since WW II or not (actually 1982 was probably worse), but I have never, before or since, seen such black pessimism as during 1958. The Dow had collapsed from a 1957 July summer high of 520 to an October low of 419. The collapse had come with little warning, and the economy started to fold soon after. By mid-1958 business was reeling and people were saying that "finally, the long-awaited post-War depression was upon us." Investors were so gloomy and pessimism so thick that it became absolutely fashionable to talk about the "great depression of the 1950s."

But something was not right with the prevailing view. I was well aware that the bull market (which began in 1949) had never progressed into its third speculative phase. Yields had never become minuscule, speculation had never become rampant, and the huge volume (that I had been expecting) had never arrived.

I noticed something else. In the face of that black atmosphere the Dow had halted its decline on October 22, 1957 at 419.79. Although the Rail Average collapsed into late-December along with most stocks, the Dow was refusing to sink below its October low. Next, as the recession deepened the short interest on the NYSE began to climb. With each passing month pessimism mounted, the short interest climbed higher and the recession deepened.

In the face of the major non-confirmation by the Dow I began to turn very bullish. But I was amazed to see that people actually became angry when I talked bullishly. Analysts were calling the stock market "crazy" because it wasn't caving in along with the economy. "Wall Street has lost its mind" was the phrase on everyone's lips. To me it was increasingly obvious: The bull market was still very much in force. -- and very sold-out.

Meanwhile, I was buying stocks. I was buying everything in sight, from Beth Steel to Sparton Corp., from Standard of Indiana to GM and GE. Then I went on margin, and all the while the market kept pushing higher. Except in 1944-46 I'd never seen such a relentless climb. I margined and I margined my margin. Every time I had an extra $500 of buying power in my margin account I bought another 100 or 200 shares of some low-priced stock.

I was wildly bullish. I was so bullish that I felt that this was the time to start an advisory publication. In early '58 I published the first Dow Theory Letters. In December of that year I wrote my first Dow Theory article for *Barron's*. That super-bullish article created quite a stir. A little 4-inch ad in Barron's pulled in 300 subscriptions within two weeks. I could hardly believe it. I was in business.

Later, calling the 1966 top helped me considerably, and calling the 1974 bear market bottom (in the face of massive pessimism) pushed subscriptions to a new high. But nothing in all my stock market adventures ever gave me the thrill of the 1957 bottom and the great bull market rise of 1958-60. That, that was a time of dramatic change. I never again went all-out on margin. Once was enough.

Then there was 1987. All during the summer of '87 I felt that the market was making a massive top. Frankly, I had never seen such a classic series of top-characteristics appear in the market. But I had to wait for a Dow Theory bear signal before I could say that the bull market was over and that the tide had turned. On October 15 the Dow Theory bear signal arrived, but it took the October 19 crash to convince people that something was wrong. I was (and obviously still am) of the opinion that the bear signal and crash of October '87 was an historic message of change, a message so powerful that it required the biggest one-day crash along with history's greatest single-day of volume to tell the story. It's a story whose meaning will only be seen and felt in years to come.

NOTES & QUOTES: At $126 billion, say the experts, the Bush S&L bailout plan is going to fall short of what will ultimately be needed. Here's a frightening comparison (which shows what has happened to the dollar): the famous Marshall plan, which literally rebuilt Europe after WW II cost a total of $50 billion. At latest count the S&L fiasco is now compounding costs at the rate of an additional $1 billion a month.

* *

What's new? The telephone company wants to replace your old copper wiring with glass cable. Glass fibers have a thousand times more capacity than the current copper cables, and the phone companies would like to compete with the cable companies by selling entertainment to customers. Federal law now forbids this, and thus a huge battle is shaping up -- cable against phone. By the way, the cost of installing glass wiring in all US homes is estimated to be around $200 billion.

* *

A Whole New Industry: Microscopic motors ("micro-machining") are now being made, motor so small that a rotor-motor driven by electricity is two-thirds the width of a hair. Says NovaSensor's Kurt Peterson, "We don't really know where all of this will take us. We're only sure that we're in the middle of inventing a whole new industry."

It's possible that within five to 10 years bypass surgery will be obsolete. In hospitals across the nation new techniques are being tried, such as tiny pulverizing rotor heads (the Rotablator) that enter the arteries and chew up artery-clogging plaque. Other techniques include hot and cold lasers that burn away the clogging materials. Competition among hospitals to be first in these new technologies is intense. If you've ever had a bypass (I had a quintuple bypass in July '87), you've got to have your fingers crossed for the success of any of the above techniques. Bypasses are now routine, but there are no fun, believe me.

* *

In a new book entitled *"The Coming Soviet Crash"* by Judy Shelton, the author claims that the Soviet economy is in disarray, and that Gorbachev's rush to *"perestroika"* represents his effort to turn Russia around before it collapses economically. Russell Comment: I tend to agree. Although I think Gorby has good intentions, I also believe that he mounted his *glosnost, perestroika,* Afghanistan pull-out, and military contraction all in an effort to stave off disaster and to impress the West. Why impress the West? Because Gorbachev knows that only Western know-how, Western help and Western loans can save the sinking Russian economy (which now spends 16% of its GNP on its military). The sides are being drawn. Some, like William Simon, are in favor of letting the Communists collapse in their own unworkable system. Others, like West Germany, are lining up to provide help and massive loans. Best guess: US banks will be big lenders (Germany, Britain and France are already lending).

* *

In his book,*"Yen,"* Daniel Burstein states that during the 1980s, the US surrendered to Japan (economically). Even the title of the book's chapters are shocking. For instance, the fifth chapter is entitled, "Burnt Teflon: How Reagonomics Sold America's Birthright for a Mess of Debt, and How Japan Became Banker to the World." Go argue with Burstein -- the 10 largest banks in the world are now Japanese.

* *

I'm hesitant to say this, because it doesn't sound very "nice" or very patriotic, but my own opinion is that today's two modern "super-powers" have passed their peak of power. I think what we are seeing now is a re-alignment of power. It is obvious to me that Russia is going downhill for the reason that Communism simply doesn't work. As Russia scales down her military in order to compete economically, her power will also decline (after all, Russia's only claim to world power was in the area of the military).

* *

As America's debts pile up, as her international trade deficits pile up, as the dollar sinks in value, it will be seen that America too has passed its peak of power. How fast America descends on the power scale is another story. Governor Richard Lamm of Colorado recently wrote this: "Like all other great civilizations that disintegrated, the US let its economy stagnate. In 1955 the US had 44% of the world's economic product, an economy eight times larger than Japan's, the world's highest productivity rate, an educational system that was second to none and a constant string of trade surpluses. By 1985, the generation in charge of America in the '60s and '70s had run up a $2 trillion debt, and the nation slipped to the lowest rate of productivity growth of any in the industrialized world. It has the highest percentage of obsolete plants, the lowest percentage of capital investment, and the highest number of functional illiterates in the industrialized world. It's productivity was half the German rate, one-third the French rate, and one-fourth the Japanese rate."

* *

I am not in favor of banning guns for citizens. If strict gun laws are enacted, I firmly believe that criminals will continue to get all the guns they want while the citizens will be left unarmed and defenseless (two weeks ago felons smashed their pick-up truck into a San Diego gun shop and cleaned the shop of dozens of guns of all types). As to those who claim that "guns kill people," rather than people killing people, consider this: In Switzerland any law-abiding citizen may own a gun and every male of military age must keep a powerful assault rifle in his home. Yet Switzerland boasts a very low rate of violence, mayhem, and murder. Violent people will always find a way to express their violence. The fact is that the US has a violent history, and nations with violent histories tend to be violent. In interviews with prison inmates the majority of inmates admitted that when mugging or breaking into a home, their main worry is that they may be facing a person who is armed.

* *

Housing prices are leveling off or softening in many former hot spots such as New England, NYC, Denver, and Phoenix. Only in Southern California are home prices still surging. Consider these exotic current examples: Joan Collins bought her Beverly Hills mansion in April '86 for $2 million. She has just put it up for sale for $6 million. Ricky Schroeder's parents have put their 9,000 square foot house up for sale for $3.3 million. Roger Moore is asking $4.9 million for his Beverly Hills house. Producer Sandy Gallin's Beverly Hills home (14,000 square feet) is on the market for, would you believe, $18 million. Meanwhile, Madonna laid out a cool $2.95 million in cash for a Hollywood Hills home.

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Sign of the Times Drink: My favorite drink these days is Sundance Natural Grapefruit Sparkler. On the label it says, "No addititives, no added sugar or fructose, no artificial sweeteners, no color added, no caffeine." No nothing but grapefruit juice and carbonated water. Try it, you'll love it.

* *

Progress Report of the week by Steve Valdivia, head of Community Youth Gang Services in LA: "I've been involved with gang work since 1967, and I've seen it go from chains and crowbars to knives to zip guns to long rifles to shotguns, and now --assault rifles." (from *LA Times*, Feb. 8).

* *

Major (League) Bucks: Two weeks ago the Mets signed pitcher Dwight Gooden to a three-year contract worth a record $6.7 million. Along with Kevin McReynold's $5.5 million contract and Ron Darling's $5.3 million contract, the Mets could face (with bonuses) a total cost of around $19 million for these three guys at the end of the three years. That's only $2 million less than the cost for the entire franchise eight years ago. Sports analyts are now talking about the possibility of the first $3 million-a-year man.

* *

What are the big American success stories in Japan? Coca Cola and McDonalds. MCD now has 637 restaurants in Japan selling Big Macs and fries to the tune of $1.2 billion a year.

* *

Sad Story: The US government, month after month, spends more than it takes in. These huge deficits create an artificial prosperity. Up to a third of these deficits are paid for by foreign funds. The US "prosperity" then spills over in the form of massive US purchases (imports) of foreign goods. This results in billions of dollars of profits going overseas. The dollars piling up overseas then come back in the form of purchases of US securities or US assets such as businesses or real estate. Below is the month-to-month story of US imports and exports along with the monthly deficits. As you can see, despite a 50% drop in the value of the dollar in terms of the major foreign currencies, our trade deficit problem is getting nowhere. How long can this go on? The fuse is burning.

Month	Imports	Exports	Deficit
Jan.	35.8	24.5	11.3
Feb.	38.9	24.5	14.4
Mar.	38.6	26.9	11.7
Apr.	36.3	26.0	10.3
May.	37.2	27.5	9.8
June	39.5	26.3	13.2
July.	36.0	26.5	9.5
Aug.	39.8	27.5	12.3
Sep.	38.7	28.0	10.7
Oct.	38.0	27.7	10.3
Nov.	39.7	27.2	12.5

* *

ISI is giving a big seminar at the Las Vegas Hiltion on March 15-17. I'll be there giving two informal 45–minute talks with a lot of time for questions and answers. Among the speakers will be Stan Weinstein, Charles Allmon, Donahue, Al Frank, and a host of others. This seminar, however, will be different. There will be no charge to Dow Theory Letters readers and your expenses will be your room and your own meals (plus whatever you lose if you're crazy enough to be a gambler). For information call 1-813-955-0323 and ask for Aaron or Ellen.

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The Bush plan for bailing out the S&Ls provides for $50 billion of 30-year bonds issued by the new Resolution Funding Corp. This agency was created so that the funding would not show on the federal budget (only interest payments of $1.4 billion will show on the deficit). The new bonds will not have the full faith and credit of the US government. How will these bonds be paid off? The S&Ls will somehow scrounge up money to buy $5 billion worth of zero-coupon bonds that will mature in 30 years at a face value of $50 billion. The mind boggles. Talk about putting things off to the future -- talk about voodoo economics!

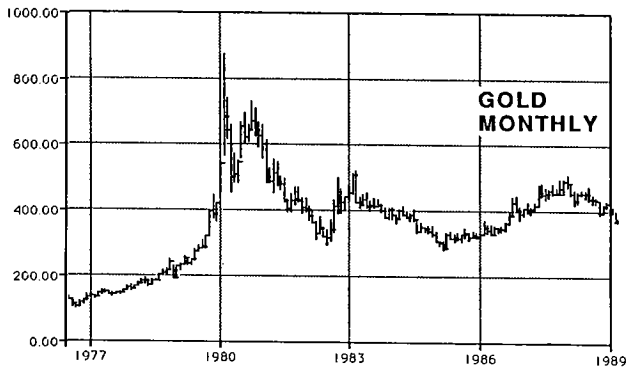
* *

Thomas Jefferson was so broke following his presidency that he had to sell his famous home at Monticello. Times have changed. Mr. Reagan will get a $1 million advance for two books for Simon and Schuster (with a probable $5 million before this deal is completed) while wife Nancy is said to have a $2 million book deal. Reagan will also get fees of $50,000 per speech, while Nancy will charge $30,000 for same.

GOLD, OIL: In dollar averaging there is one great danger. That danger is that the item you're dollar averaging is going to go bankrupt. This is (as I've outlined before) not a problem with gold. In fact, gold is one of the very few items that can't go belly-up. Dollar average a declining stock and you can find yourself in major trouble since you could be dollar averaging an item that is headed for zero. But in our compaign of gold accumulation, all the declining bullion price means is that we accumulate more gold each month for our fixed-dollar investment.

This monthly chart (courtesy of *Dunn & Hargitt)* provides long-term perspective for gold, and you can see that since early

1980 gold has really been in an extended trading range bordered by 520 on the high side and 285 on the low side.



The divergence between the gold shares and the metal is now spectacular with gold breaking to new lows around 380 while the XAU gold/silver stock average holds well above 90 -- its recent low was 84. 81.

Undoubtedly the pressure on gold stems from the almost irresistible attraction of today's fat interest rates. This is one of those rare instances where interest rates are rising while there doesn't seem to be any long-term real fear of inflation. (Note that the CRB Commodities Futures Index is floundering around in the 240 or below area, well under its recent high of 252.)

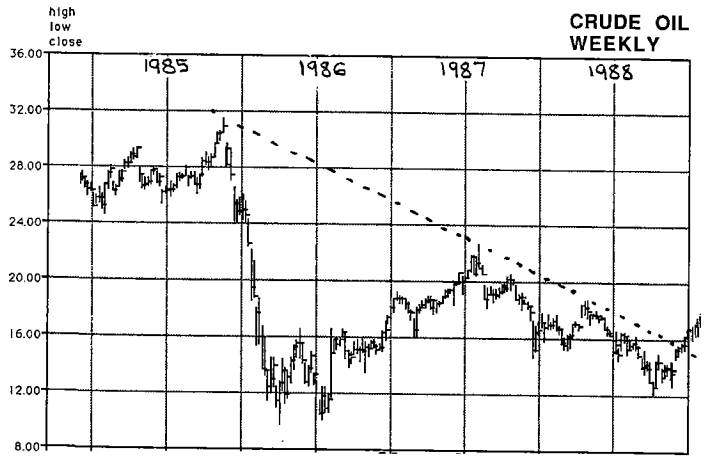
Meanwhile, the Fed continues to walk the tightrope between inflation (as witness the jump in the Producer Price Index and the rise in the price of oil) and deflation (as witness the collapse of the S&Ls and the topping out of bellwether copper). Where and how will it all end? The jury is obviously still out.

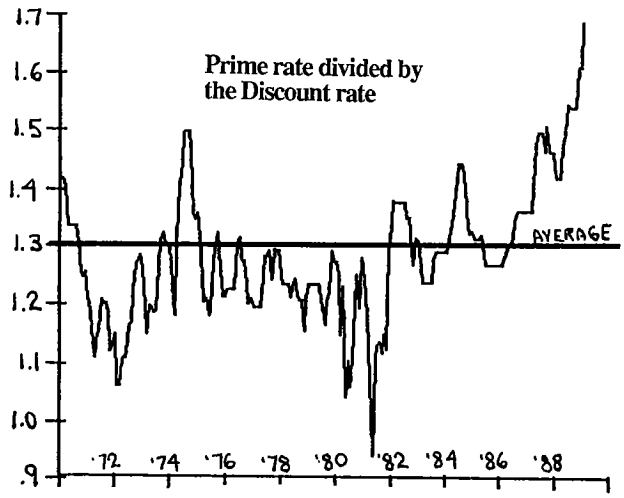
OIL: Oil ("Black Gold") may be the single most important component of inflation. (1) January was the third month in a row that US oil deliveries bettered last year's levels. (2) In January, for the first time in 10 years, the US imported more oil than it produced. (3) January imports of oil jumped 20% over a year ago while domestic production was down 3.4% for the same period. "What you're seeing is the future," was the ominous comment of Charles DiBona, president of the American Petroleum Institute. (On Feb. 15, spot crude surged above the $18 a barrel level.)

For a better perspective, I am including this weekly chart (top-right on this page) of crude oil, courtesy of *Dunn & Hargitt.*. Few people realize it, but the entire declining trend in oil from its 1985 peak has recently been reversed to the upside. Furthermore, OPEC may be getting its act together, which would mean planned cut-backs in oil production. Watch 18.50 on the April crude contract for an upside breakout. Better 18.50, and oil is on its way again -- and the way is up.

LATE NOTES: Chart of the week: The chart (middle of the right-hand column) shows the prime bank rate (now 11%) divided by the discount rate (now 6.5%). As you can see the ratio is currently at its highest level in modern history (probably the highest ever). What this chart tells us is that the Fed is holding back on raising the discount rate while the prime rate (which is what the banks charge their best customers) is pushing skyward. According to Ed Hyman of *CJ Lawrence,* the prime/discount ratio indicates that the "discount rate should be 8.50%" (chart courtesy of *CJ Lawrence*). In Canada, by the way, the big banks just raised their rates to 12.75%.

Why is the Fed holding back? It is obviously fearful of what a boost in the discount rate would do to the markets (a discount move is always very official and indicates clearly the Fed's intentions). One change has occurred however, and it's the globalization of the markets. Thus, foreign money pouring into the US makes it much more difficult for the Fed to control monetary matters.





STOCK MARKET: In the stock market the near-term numbers I'm watching are the February 8 high of 2347.14 for the D-J Industrials and 1087.97 for the Transports. For the bulls, it will require a bettering of BOTH of these highs for an "all-clear" signal (i.e., a signal for a continuation of the bullish trend). For the bears, a recovery high by one Average, unconfirmed by the other, would be a first hint of a reversal and impending trouble.

A study of market history shows that it is very unusual for the market to rise to a peak, and then suddenly turn down with no technical hints of a reversal. In the vast majority of cases, a non-confirmation in the Averages will precede a major reversal (this is true both at tops and at bottoms).

In the meantime my PTI continues to act bullishly -- on February 16 it hit an all-time high of 2910. The PTI is now 74 points above it moving average (this is a record and suggests that the market is very over-bought). Surprisingly, however, DowPow continues to act sluggishly, indicating that breadth is still lagging. (More on DowPow in the next Letter.) Final item: The fierce battle for funds becomes even more intense with CDs in California nearing 10%. The public is going for the juicy rates, and who can blame them!

LATE RUSSELL NOTE: Besides being a newspaper and magazine and general reading nut, I'm also a movie freak. In my humble opinion, there are two great actors going today, Dustin Hoffman and Robert Deniro and two more who are fast making my list, William Dafoe and James Woods. The *New York Times* gave Woods' new movie, "True Believer," a rave. I'm seeing it tomorrow. I've been a Woods fan from way back (when he was still making "B" movies).

NEXT MAILING: March 8